No. 12481

In The United States Court of Appeals
For the Ninth Circuit

FAY J. HANSEN, *Appellant,*

vs.

ERNEST A. JONSON, Receiver of Vita-Pakt Associates, Inc., an insolvent corporation, and R. C. NICHOLSON, Trustee of the Estate of Fay J. Hansen, bankrupt, *Appellee.*

APPEAL FROM THE UNITED STATES DISTRICT COURT, FOR THE WESTERN DISTRICT OF WASHINGTON, NORTHERN DIVISION

ANSWERING BRIEF OF APPELLEE, ERNEST A. JONSON, RECEIVER OF VITA-PAKT ASSOCIATES, INC., AN INSOLVENT CORPORATION

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In The United States Court of Appeals

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Appeal from the United States District Court for the Western District of Washington, Northern Division

ANSWERING BRIEF OF APPELLEE, ERNEST A. JONSON, RECEIVER OF VITA-PAKT ASSOCIATES, INC., AN INSOLVENT CORPORATION

INTRODUCTION

The portion of the brief of the Appellant, Fay J. Hansen, on which he seeks to reverse the judgment awarded the Appellee, Ernest A. Jonson, Receiver of Vita-Pakt Associates, Inc., and to which this Answering Brief is directed appears under the headings numbered IV, V, VI, and VII, and on pages 35 through 46 of Appellant's brief. The facts out of which the controversy in question arose are of vital importance. Appellant's Statement of the Case is deemed incomplete and therefore Appellee has made a detailed Statement of the Case and it is supported from the Transcript of the Record. Appellant's presentation of the issues involved does not appear to present them as Appellee

views them; therefore, Appellee has stated issues and presented argument first without reference to Appellant's brief, and then specifically answers Appellant's argument.

Appellant's Statement Showing Jurisdiction of the Court of Appeals of this appeal is not controverted.

STATEMENT OF THE CASE

In July, 1947, Fay J. Hansen commenced selling fresh orange juice in Seattle, Washington. Prior to December, he acquired a partner, one Paul D. Shaeffer, and the business was expanded to include the production, as well as sale, of fresh orange juice. As of December 31, 1947, the business had a net operating loss of approximately $15,000.00 (R. 314, Rec. Ex. 27), and the net worth was $14,014.13, consisting principally of $6,000.00 in good will and $3,870.30 denominated as drawing account of Fay J. Hansen. Hansen and Shaeffer agreed to dissolve the partnership as of December 31, 1947, Hansen to purchase Shaeffer's interest for $17,000.00. Hansen then promoted the corporation known as Vita-Pakt Associates, Inc. Articles of Incorporation were filed on February 3, 1948. Fay J. Hansen and Rosemary Hansen, his wife, and Thomas Todd (of the Seattle Bar) were the incorporators and first directors (R. 113 and 134). Authorized capital stock was 1,000 shares of no par stock. The paid in capital was $500.00.

Hansen was President and a member of the Board of Directors from the date of the first meeting to a time shortly prior to the appointment of the receiver in August, 1948. Mrs. Hansen was Secretary-Treas-

urer and a member of the Board of Directors through the same period. Thomas Todd was elected Vice-President and resigned and Dr. Burkhart succeeded him in office, both as Vice-President and as a member of the Board of Directors (R. 134).

Hansen agreed to transfer all of the assets of the partnership business, subject to its liabilities, to the corporation in exchange for 530 shares of stock of the authorized value of not less than $100.00 per share (R. 103, Rec. Ex. 27). The corporation received all of the assets of the partnership. No formal instrument of transfer was executed.

Books of account of the corporation were opened as of January 1, 1948. The closing entries of the partnership books were transferred to and became the opening entries of the corporation books (R. 210, Rec. Ex. 27).

Only one certificate of stock, the qualifying share, was issued to Hansen (R. 118). This was transferred to Dr. Burkhart, as shown by the stock records. Certificates for 615 shares of stock were issued by the corporation for which the corporation received $51,900.00 (R. 223, and R. 216, Rec. Ex. 27). 519 shares were issued on cash sales at $100.00 per share; 96 shares were issued as bonus stock.

Hansen, as promoter, as President, as General Manager, and as a member of the Board of Directors, assumed to dominate and did dominate all the affairs and activities of the corporation. The books of account and records of the corporation were opened and maintained under his direction and supervision. He directed

the manner in which cash received from the sale of stock was entered in the books of account of the corporation and, at all times during the active existence of the corporation, had possession of its books and records. The information contained in the books and records was not conveyed to the stockholders at any meeting duly authorized, or in any manner whatsoever throughout the entire corporate existence (R. 116-118, 170). No mention was made by Hansen to the stockholders that the money received from the sale of stock was not the property of the corporation or that any portion of the money was credited to Hansen by way of a "Drawing Account" or that Hansen had pledged the credit of the corporation to obtain real or personal property which he claimed as his own, or that Hansen had an interest in and to any money received from the sale of stock or an interest in and to any shares sold for cash (R. 93, 96, 119).

Certificates for 615 shares, as stated, were issued by the corporation. Hansen set up an account in the general ledger entitled "Capital Stock Sales." Credited to the corporation from such sales was $51,900.00. This capital stock sales account showed only cash received. Hansen, who had the stock records, issued 96 shares as bonus stock (R. 214, Rec. Ex. 27, R. 222, 224).

Hansen, as President and General Manager, sold each share of stock for which cash was received, on the representation that he was drawing a salary of $100.00 per week and nothing more from the business; that the proceeds from the sale of stock were needed and were to be used by the corporation for working capital. During the entire period in which stock sales

were effected, Hansen made no statement to any person that he was selling all, or a portion of, the 530 shares which were to be issued to him. On the contrary, he stated from time to time that he was issuing and he did issue shares of stock as bonus stock stating that same were from "his own private stock" as an inducement for the purchase of stock and the loaning of money to the corporation (Tr. p. 94). Hansen set up a "Fay J. Hansen Drawing Account" in the general ledger without any corporate resolution of any kind, and he proceeded to draw a sum slightly in excess of $16,000.00, as shown from the drawing account (R. 219, 220, Rec. Ex. 27). This money was used by Hansen for his own purposes at various times. During the period in which Hansen was unlawfully appropriating the corporation's funds, the corporation operated at a loss and did not have sufficient moneys to operate and pay the various drafts which were drawn in favor of Hansen and others (R. 112, Rec. Ex. 2, R. 119-121). Hansen borrowed money from stockholders from time to time as indicated from the "Note Payable Account" of the books (R. 212, Rec. Ex. 27). These funds together with receipts from the sale of stock and sales of merchandise all were received by the corporation and went into the corporation bank account (R. 125). Hansen, to assist himself in acquiring property for himself individually, engaged in a process of kiting checks between the corporation bank account in the Bank of California and his personal account in the Seattle-First National Bank (Broadway Branch). These entries were carried in the general ledger of the corporation

under the heading "Special Loan Account." (R. 216-218, Rec. Ex. 27).

The details of the entire matter in which Hansen appropriated the money of the corporation were known only to himself and his wife, the additional director (R. 226). No meeting of the directors was ever held, nor was any stockholders' meeting ever formally called or held. In the course of time, the corporation became hopelessly insolvent. The stockholders did not become suspicious of Hansen's manipulation until the latter part of July, 1948. Hansen had been misrepresenting conditions to them to keep them satisfied (R. 121-123, Rec. Ex. 8). An audit of the books by a certified public accountant engaged by the stockholders revealed for the first time the fact that Hansen had appropriated a sum in excess of $16,000.00 to his own uses and purposes and, thereafter, the stockholders, acting with diligence, confronted Hansen with the information they had acquired.

As previously mentioned, some of the stockholders engaged a certified public accountant the latter part of July and also engaged a lawyer, Mr. Elvin P. Carney, to investigate the condition of the corporation and take action to protect the corporation and the stockholders. At a meeting held on July 24, 1948, attended by some of the stockholders, Hansen, the accountant and the attorney, Hansen admitted his false representations in selling stock and procuring loans and that the company was virtually insolvent, but he did not then disclose the fact of his unauthorized withdrawal of corporation funds.

On July 29, 1948, Hansen went voluntarily to the

office of Mr. Carney and, with the accountant present, Hansen was confronted with the fact that he had sold stock and procured loans on misrepresentations and that he had misappropriated corporation money. In the discussion that followed, Hansen admitted withdrawing funds from the corporation bank account and using the same for the purchase of his house, car and furniture. He then claimed for the first time that of the stock that was sold, some of it was his; that he considered himself entitled to all the money charged to the Fay J. Hansen Drawing Account as a matter of right. As a result of the entire discussion, which covered a period of approximately an hour, more or less, Hansen agreed to transfer his property to the corporation. He voluntarily went out and got his wife and returned (R. 92, 93). Two stockholders were present on their return. Hansen and wife resigned as officers and directors and their successors were elected and Hansen and his wife executed instruments of conveyance conveying property to the corporation, as follows:

Bill of Sale to automobile;

Quitclaim Deed to residence property, 4113 S. W. 109th Street;

Purchaser's Assignment of Real Estate Contract, being Lot 1, Block 3, Arroyo Vista, a vacant lot, purchased in part by Mrs. Hansen prior to the marriage;

Bill of Sale to appliances and furniture.

Hansen and wife were not restrained or coerced in any manner nor was any force or threats of any kind made to them to induce or persuade them to execute and deliver the aforesaid instruments, and Hansen and

wife executed and delivered the instruments voluntarily and of their own free will.

Ernest A. Jonson was appointed temporary receiver of Vita-Pakt Associates, Inc. on August 4, 1948. His appointment was made permanent and he qualified on August 9, 1948. The corporation was hopelessly insolvent. It appeared from records of the corporation that the corporation had sustained substantial operating losses in January and each month thereafter during its operation. It further appears, in reference to the corporation, that there was no account showing a liability of the corporation to Hansen, nor was there any account showing funds received from the sale of any of Hansen's stock (R. 222, 223). There is no account whatsoever in the corporation records that tends to substantiate in any respect Hansen's claim that he was selling his own stock.

On August 5, 1948, Hansen filed a voluntary petition in bankruptcy and claimed exemptions in his house, furniture and automobile. Further proceedings had in connection with the exemptions are set forth in the appellant's statement of the case. The bankrupt and the Trustee petitioned the Referee in Bankruptcy to issue an order citing the receiver of Vita-Pakt Associates, Inc., into court to show cause why the transfers previously made by Hansen should not be set aside. The receiver resisted such action, denying that the transfers were void under any part of the bankruptcy act and denying that the transfers constituted a voidable preference, and claimed that the transfers consisted of the return of property to the corporation, purchased in substantial part with corporate funds and

that to the extent that corporate funds were traced into the property the transfers should be sustained. The Referee in Bankruptcy, after trial of the matter, entered an order adjudging the transfers made by the bankrupt to be void. The findings of fact of the Referee are to be found on pages 35 through 44 of the transcript. The decision of the Referee was reversed by the District Court on the petition of the receiver of Vita-Pakt Associates, Inc., appellee herein, for review of the Referee's order. The decision of the District Court was that the sum of $5,500.00 of corporation funds was traced into the Hansen residence and the sum of $397.00 of corporation funds was traced into the automobile, and such funds less certain expenses were awarded to the receiver. A detailed analysis of these transactions is as follows:

1. Hansen, without any authority of the Board of Directors or the stockholders, and without their knowledge, withdrew corporation funds from the corporation bank account for his own personal use. On April 15, 1948 Hansen issued his own personal check for $397.00 on the Seattle-First National Bank (Broadway Branch) as down payment on a 1948 Oldsmobile, which check was presented for payment by the payee and paid at a time when funds in Hansen's personal account consisted of corporation funds appropriated by him by way of corporation check to his favor and deposited in his personal account.

2. On March 11, 1948, Hansen issued his personal check for $1,000.00 in favor of Herbert U. Taylor as down payment on premises known as 4113 S. W. 109th Street, Seattle, Washington, being property purchased from said Taylor. Taylor by agreement

withheld sending the check in for collection. On March 16, 1948, Hansen caused to be issued a corporation draft in favor of himself in the sum of $1,100.00 and charged the same to his drawing account. This check was deposited in his personal account and the $1,000.00 check to Taylor was presented for payment and paid from the corporation funds in his personal account.

3. Hansen made a further payment on the price of the residence by pledging the credit of the corporation and appropriating the proceeds thereof. As President of the corporation he executed a note in favor of Dr. John B. Kiefer on June 30, 1948, in the sum of $3,000.00 and a note to Dr. C. M. Starksen in the sum of $2,000.00 evidencing funds loaned to the corporation (R. 222, Rec. Ex. 30). He received the proceeds on June 30, 1948, and deposited the same in the corporation bank account on the same day (Rec. Ex. 32). Prior to that deposit, the corporation had an overdraft in its account at the Bank of California. After the deposit, Hansen procured a cashier's check in the sum of $4500.00 which was charged against the corporation bank account and made payable to Herbert U. Taylor and was applied by Taylor on the price of the residence purchased by Hansen (R. 142-145), Rec. Ex. 33).

Hansen admits that funds went into the purchase of the house as claimed (R. 160) and also admits that the car was purchased with such funds. The Referee in Bankruptcy in his memorandum decision stated with reference to proof of tracing of funds from the corporation bank account into the property as follows (Tr. p. 32):

> "The receiver met the burden of proving that $4500.00 was taken out of the bank account of the

> corporation and paid to one Taylor for building a house for Hansen's personal use on real estate standing in his name, and other transactions were proven with like clarity."

but declined to make a finding to that effect.

It is considered that the issues as raised by the appeal of the appellant are as follows:

1. Was the appropriation by Hansen of funds from the bank account of Vita-Pakt Associates, Inc. a misappropriation of corporation funds?

2. Were such funds traced into the property purchased by Hansen and wife?

3. Was the transfer by Hansen and wife to Vita-Pakt Associates, Inc. a preference within the meaning of the Bankruptcy Act and therefore voidable by the Trustee of the estate of the bankrupt?

4. Was the transfer by Hansen and wife of the property in question to Vita-Pakt Associates, Inc. made under circumstances constituting legal duress?

ARGUMENT IN SUPPORT OF JUDGMENT IN FAVOR OF APPELLEE

I.

Was the Appropriation by Hansen of Funds from the Bank Account of Vita-Pakt Associates, Inc., a Misappropriation of Corporation Funds?

This issue involves several related legal points which will be presented first.

1. Hansen, as an officer and director had a fiduciary relation to the corporation and its stockholders and was a trustee of the corporation property in his custody and could not act in a manner adverse to the corporation, its property, and its stockholders.

Remington's Revised Statutes of Washington, (1939 Supplement) Sec. 3803-33;

Sacajewea Lumber & S. Co. v. Skookum, 116 Wash. 75, 198 Pac. 1112;

Clark County v. Hiim, 177 Wash. 251, 31 Pac. 905;

Shuey v. Holmes, 22 Wash. 193 (1900);

Hein v. Forney, 164 Wash. 309, 2 P. (2d) 741;

Fletcher, Cyclopedia of Corporations (Perm. Ed.) Vol. 3, Secs. 854, 910, 1077, 1113.

Rem. Rev. Stat., Sec. 3803-33 provides as follows:

> "Officers and directors shall be deemed to stand in a fiduciary relation to the corporation, and shall discharge the duties of their respective positions in good faith, and with that diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions."

In *Sacajewea Lumber & S. Co. v. Skookum, supra,* the court stated at page 78:

> "A director of a corporation occupies a strictly fiduciary capacity and it is always his duty to fully represent the interests of the corporation of which he is a director."

In *Clark County v. Hiim, supra,* D, an officer of P, loaned money to B, taking a chattel mortgage on 200 head of cattle. Some cattle were sold and D converted the funds to his own use. P sued D and his surety, and

D contended that the cattle were in fact owned by him and that the converted funds were used by him to purchase more cattle and thus P's security was not impaired. Such evidence was held inadmissible under the pleadings, but with respect to the right of D generally to make such defense, the court stated:

> "Assuming the absence of the rule which requires the pleadings of affirmative defenses, appellants will not be heard to say that the cattle were, in fact, owned by Hiim, who was a fiduciary officer and employee of the respondent. This employee made a loan of his employer's money to Bethea. He represented his employer, and the mortgage so recites, that Bethea was the sole owner of the cattle. He permitted Bethea to sell some of the mortgaged cattle, and then accepted the proceeds of such sales with the understanding that the money would be used in payment of the chattel mortgage. That money was diverted by Hiim to his own use—none of it was turned over to Hiim's employer, the one entitled thereto. Neither Hiim nor his surety is in a position to say that Hiim did not receive the money as agent for the respondent. Hiim was acting in a fiduciary capacity and his misappropriation of the money turned over to him by Bethea, the money which he knew belonged to respondent, makes Hiim responsible therefor."

In *Shuey v. Holmes, supra,* D gave his note to the bank, of which he was director and a stockholder, in payment of shares of bank stock; on insolvency of the bank and suit by the receiver on the note, D filed an answer stating that the note was given merely as accommodation in that he intended to take the stock only temporarily until it could be sold and paid for by actual

purchasers, as the bank had come into ownership of the stock and could not legally own it. The demurrer to the answer was sustained, the court stating at page 195:

> "As against creditors of the insolvent bank, who were represented by the plaintiff in the present action, the defense must be regarded as insufficient, and the case as presented upon the present appeal, falls within that of *Barto v. Nix,* 15 Wash. 563, (46 Pac. 1033) wherein it was said:
>
> ' "A director is an officer of the bank, and it is through the board composed of himself and his associates that its business is transacted. To hold that one of these can make a note to the bank and to have it taken up as a part of its assets, and afterwards, when such a note is sought to be enforced against him in the interests of the creditors of the bank, set up a secret agreement which nullifies the note, would be contrary not only to all legal rules but to all principles of justice.'
>
> "To hold otherwise would be to open the door to the frauds of the grossest character. To uphold a secret agreement of the character here set up, as against creditors, would be a dangerous innovation."

Hein v. Forney, supra, holds that directors of an insolvent corporation cannot prefer themselves at the expense of creditors. That the same rule applies to stockholders, see *Mitchell v. Jordan,* 36 Wash. 645, 79 Pac. 311.

2. Where one in a fiduciary capacity mingles trust property, with his own property, the burden is upon him to establish what property is his.

Collier on Bankruptcy (14th Ed.) Vol. 4, page 1144;

Remington on Bankruptcy (4th Ed.) Vol. 5, Sec. 2465, page 790;

Pomeroy's Equity Jurisprudence (5th Ed., Symons) Vol. 3, Sec. 1058d;

Tucker v. Brown, 20 Wn. (2d) 740, 150 P. (2d) 604;

In re Royea's Estate, 143 Fed. 183 (D. C., Wash., WD, ND, 1906);

National Bank v. Insurance Co., 104 U. S. 54, 26 L. ed. 693.

In *Tucker v. Brown, supra,* the Washington court states the general rule, which is also found in the remaining citations, as follows:

> "(19) The general rule is that the claimant of a trust must, in cases where the rights of creditors are affected, trace the fund by evidence that is clear and satisfactory. (*Rugger v. Hammond,* 95 Wash. 85, 163 Pac. 408) and that, if he fails to so trace and identify the fund, his claim is that of a general creditor. *Davis v. Shepard,* 135 Wash. 124, 237 Pac. 21, 41 A.L.R. 163; *In re Jordan's Estate,* 171 Wash. 624, 18 P. (2d) 855.
>
> "However, after the trust is proven and property and funds identified, the burden is on the trustee to account in a satisfactory manner for the property and funds, 65 C.J. 904, Trusts Sec. 799."

In *In re Royea's Estate, supra,* the bankrupt has trust funds in his personal bank account, the balance of which $390.10, was turned over to his trustee. Claimant's claim to recover the trust funds was defended on the theory that where the bankrupt had mingled trust funds with his own, the identify of the trust funds was lost and such funds could not be recovered. This contention was rejected, and allowance of the claim affirmed on review. The court cited *National Bank v. Insurance Co., supra,* quoting from the syllabus:

> "As long as trust property can be traced and followed, the property into which it has been converged remains subject to the trust; and, if a man mixes trust funds with his, the whole will be treated as trust property, except so far as he may be able to distinguish what is his. This doctrine applies in every case of a trust relation, and as well as to moneys deposited in a bank, and to the debt thereby created, as to every other description of property."

and, continuing, the court said:

> "In this case, although the money can not be specifically identified, the fund is clearly proved to have been enlarged by mingling trust money with other money, and the equitable right of the petitioner to reclaim an amount equal to the amount entrusted is clear."

Coming now to the factual part of the issue, we will examine Hansen's contentions. He contends that the funds withdrawn from the corporation bank account and charged to his drawing account (R. 219, Rec. Ex. 27) and used to purchase the house and car were his funds, and that such funds were the proceeds from the sale of his stock (R. 152, 161; Par. VI, pp. 40-42,

appellant's brief). He admits that proceeds from the sale of orange juice, of loans for the corporation, and from the sale of stock all went into the corporation bank account (R. 124-125; 160-161). He admits that he cannot identify just what shares of stock he ever owned (R. 118-119), or what shares of his were ever sold, or when any of his shares were sold, or to whom his shares were sold (R. 118-119; 124; 162-163; 236) or how many shares he owned on the day he conveyed the property in question (R. 236). He made a belated effort to compute his shares (R. 162-167) and to identify a purchaser of certain shares (R. 237) but such testimony is entirely inconsistent with his prior testimony.

Hansen's bald assertions constitute the sole evidence, if it can be called evidence, in support of his contentions. The record completely disputes Hansen's testimony. But one share was ever issued to him, which he admits (R. 118). The corporation by-laws with respect to issue and transfer of shares were not compiled with (R. 105-106, Rec. Ex. 2; 176-177). The corporation books contained no account of any of Hansen's stock transactions (R. 222-223; 214-216, Rec. Ex. 27). No one else knew that Hansen was selling his stock, and he did not tell the stockholders, nor a prospective stockholder that his, Hansen's, stock was being sold (R. 93-94; 96; 118-119).

Of the funds used by Hansen to purchase his house, it is undisputed that $5,500.00 came from the corporation bank account (R. 156, 160). It is also undisputed —Hansen nowhere ever contradicts the record—that $4,500.00 of such funds was the proceeds of the loans from Dr. Kiefer and Dr. Starksen as evidenced by

Receiver's Exhibit 27 (R. 213); Exhibit 30 (R. 222); 32 (not in the transcript), 33 and 34 (R. 142-145). Hansen's case to that extent completely fails. As to the remainder of his case, it is simply a question of whether any of Hansen's testimony can be believed and whether the requirements of the applicable law as heretofore set forth have been met. As to the law, Hansen was an officer and a stockholder of the corporation and as such had a fiduciary relation to the corporation and its stockholders (Rem. Rev. Stat., Sec. 3803-33, *supra*).

He admittedly mingled his own funds (if we believe him) with corporation funds (R. 124-125, 160-161) and under the law previously cited had the burden of identifying his funds and property and segregating the same from the corporation funds which were trust funds. Under the decision of *Clark County v. Hiim, supra,* Hansen could not assert ownership to the funds in the corporation bank account. Under the decision in *Shuey v. Holmes, supra,* he could not set up a secret agreement between himself as an individual and himself as an officer and director of the corporation that would serve to defraud the corporation, its stockholders and creditors. Under the decision of *Hein v. Forney, supra,* even if it were considered that his depositing the proceeds of stock in the corporation bank account constituted a loan and an indebtedness to him were established, he could not prefer himself by paying any indebtedness due him from the corporation. As to the credibility of Hansen's testimony, it is submitted that evasive, self-contradicting and inconsistent testimony is not worthy of belief. Furthermore, the testimony of an admitted swindler (R. 96-102, 121, 125) is hardly

worthy of belief when it is against the interests of innocent people. The word of a man who represents his net worth as $70,000.00, based on stock ownership of a corporation that had an operating loss of $35,000.00 for five months (R. 166-167) and who valued a business having a net worth of approximately $14,000.00 and an annual deficit of $15,000.00 as worth "does not exceed the sum of $100,000.00" is hardly worthy of belief.

It is submitted that the Referee in Bankruptcy in his Memorandum Decision (R. 23, at p. 32) and Findings of Fact No. XII (R. 42-43) placed the burden of proof on the wrong party when placing it upon the Receiver to prove the amount of Hansen's stock or funds as was done; and in any event was incorrect in holding that the Receiver had not established a trust fund. It was admitted that as of June 25, 1948, of the stock that had been sold, $26,000.00 was property of the corporation and to which Hansen had no claim (R. 108, Rec. Ex. 2; p. 116, 130)—thus there were corporation funds with which the fiduciary (Hansen) mingled his own funds (if we believe him). It is further submitted that, as decided by the District Court, the Referee's Findings of Fact were clearly erroneous and that there is no evidence to support them.

II.

Were the Funds So Misappropriated by Hansen Traced Into the Property Purchased by Hansen and Wife, Specifically the Residence and Automobile?

As set forth in the statement of the case, *supra,* pp. 10-11, the Referee in Bankruptcy stated in his Memorandum Decision that the Receiver did trace funds as

claimed from the corporation bank account into the residence and did trace other items, which included the automobile (R. 23, at p. 32). Hansen admitted that $5,500.00 went into the house (R. 156, 160) and that $397.00 went into the automobile (R. 149). Furthermore, it is undisputed that $4,500.00 was the proceeds of loans made on behalf of the corporation and was withdrawn from the corporation bank account on June 30, 1948 (R. 142-145, Rec. Ex. 33 and 34), and furthermore, nowhere in appellant's brief is the fact of the tracing of the funds resisted.

III.

Was the Conveyance and Transfer by Hansen and Wife of Property to Vita-Pakt Associates, Inc., a Preference Within the Meaning of the Bankruptcy Act and Voidable by the Trustee of the Estate of the Bankrupt?

Where trust funds or other property are converted by the bankrupt they may be traced and recovered, so may its proceeds, if they can be identified and traced; and repayment or return by the bankrupt of such property or property into which the same can be traced does not constitute a preference that can be avoided by the trustee in bankruptcy.

1. ***Trust funds or property may be traced and recovered from a trustee in bankruptcy.***

Cook v. Tullis, 18 Wall (U.S.) 332, 21 L. ed. 933;

Thomas v. Taggert, 209 U.S. 385, 52 L. ed. 845, 28 S. Ct. 519;

Morris Plan Industrial Bank of N. Y. v. Schorn, 135 F. (28d) 538 (2 Cir., 1943);

In re Franklin Savings & Loan Co., 34 F. Supp. 585, (D.C., Tenn., 1940);

In re Franklin Savings & Loan Co., 34 F. Supp. 661, (D.C., Tenn., 1940);

Remington on Bankruptcy (4th Ed.) Vol. 5, sec. 2463, 2464, p. 743;

Pomeroy's Equity Jurisprudence (5th Ed., Symons) Vol. 4, sec. 1058b, 1058c.

In *Cook v. Tullis, supra,* the trustees in bankruptcy sought to recover a note and mortgage conveyed to defendant by bankrupt, the same being in substitution of bonds held by bankrupt for safekeeping and converted. The Court found for the defendant, stating at page 937 (21 L. ed.):

> ". . . still the trustees must fail in their suit. They took the property of the bankrupt subject to all legal and equitable claims of others. They were affected by all equities which could be urged against him. Now it is a rule of equity jurisprudence, perfectly settled and of universal application, that where property held upon any trust to keep, use, or invest it in a particular way, is misapplied by the trustee and converted into different property, or is sold and the proceeds are thus invested, the property may be followed wherever it can be traced through its transformations, and will be subject, when found in its new form, to the rights of the original owner or cestui que trust."

The case of *In re Franklin Savings & Loan Co.* first cited, *supra,* involved a preferred claim to funds as trust funds in the hands of the trustee. Stock had been converted by the bankrupt and pledged as security for notes given another bank. On default, the stock was

sold and proceeds applied on the note and the balance returned to the bankrupt with the notes, which ultimately came into the hands of the trustee. The referee's decision denying the preferred claim was reversed on review, the court holding that the claimant was entitled to trace her property into the balance of funds in the hands of the trustee and was also subrogated to the rights of the payee of the notes.

In the second *In re Franklin Savings & Loan Co.* case, *supra,* the bankrupt had converted stock certificates and pledged them as security for a loan. Proceeds of the loan were re-loaned and notes received which were pledged as security for other loans. Funds and notes traced from the original loan were in the hands of the trustee in bankruptcy. The district court reversed the decision of the referee and held that the funds and notes evidencing the original funds received on converting and pledging stock were traced and could be recovered.

2. *Return of trust property or proceeds of property into which traced does not constitute a voidable preference.*

Fisher v. Shreve, Crump & Lowe Co., 7 F. (2d) 159 (D.C., Mass. 1925);

Rockmore v. American Hatters & Furriers, 15 F. (2d) 272 (2 Cir.);

Collier on Bankruptcy (14th ed.) Vol. 4, Sec. 60.18, p. 814-15;

103 A.L.R. 310, annotation entitled "Restoration of or making compensation for money or property obtained by breach of trust,

> fraud, or other tort, as a voidable preference under the bankruptcy act."

The general rule is stated in 103 A.L.R., 310, at p. 311, as follows:

> "II. Restoration of specific money or property, or its proceeds.
>
> "The restoration of the specific money or property that the bankrupt had obtained by breach of trust, fraud, or other tort, or money or property into which it can be traced under the rules of equity with regard to tracing trust property, is not a voidable preference under the American Bankruptcy Act, where by reason of the tort the one to whom it is restored has a right to rescind the transaction by which he was deprived of it and to recover the specific money or property, or its proceeds from the bankrupt, since such a restoration is merely a return of the money or property to its rightful owner, and not a transfer of the property to a creditor. (citing cases)."

In *Rockmore v. American Hatters & Furriers, supra,* the court held that the return by the bankrupt of the identical fur skins, together with promissory notes covering fur skins sold, to the vendor, within four months prior to bankruptcy was not a voidable preference.

It is submitted that on the basis of the foregoing decisions and references, the corporation was entitled to trace the funds of the corporation as misappropriated by Hansen, its officer and director, into the property purchased by Hansen; and to the extent that the funds were traced, as set forth previously herein, the return and conveyance of the property by Hansen to the cor-

poration is not a voidable preference, and the judgment in favor of the Receiver should be affirmed.

IV.

Was the Transfer by Hansen and Wife of the Property in Question to Vita-Pakt Associates, Inc., Made Under Circumstances Constituting Legal Duress?

The burden of proof is on the bankrupt to prove duress. In transactions involving the making of contracts, settlements or compromises arising out of claims asserted in good faith against the complaining party, there is a presumption of want of duress. One smarting under a wrong may advise the other party that he is subject to criminal prosecution if the wrong is both civil and criminal in its nature, and such act does not constitute duress.

Thorne v. Farrar, 57 Wash. 441, 107 Pac. 347;

Ingebright v. Seattle Taxicab & Transfer Co., 78 Wash. 433, 139 Pac. 188;

Bertchinger v. Campbell, 99 Wash. 143, 168 Pac. 977;

Cooley v. Davis, 114 Wash. 196, 194 Pac. 968.

In Thorne v. Farrar, supra, the court refused to annul a marriage entered into on the day following threats of criminal prosecution to plaintiff, stating that time elapsed from the time of the threats to time of marriage during which plaintiff had an opportunity to seek advice of counsel, and quoting from *Meredith v. Meredith,* 79 Mo. App. 636:

> "Threats and acts of intimidation do not necessarily prove duress, and where the party was under a moral obligation to enter into or discharge a contract, the presumption is that he acted from

a sense of moral duty, and this presumption should be weighed in the scale against the evidence of duress. . . .''

In *Bertchinger v. Campbell, supra,* the court stated as follows:

''. . . there is running through all the decisions relied upon by counsel for respondent in this case the element of presumption that, when one yields to a demand made upon him in good faith, accompanied by a fair show of legal right in the one making the demand, he does not yield because of duress in the legal sense.''

In *Ingebright v. Seattle Taxicab & Transfer Co.,* the court refused to set aside a transfer of a truck by plaintiff to defendant company made in settlement of claims of defendant against plaintiff for funds admittedly misappropriated by plaintiff. Defendant's officers and attorney had threatened plaintiff with criminal prosecution, or rather had advised him that he was subject to criminal prosecution, but no force was proven, and plaintiff had been permitted to leave the conference room twice. The court stated (p. 436):

''Do these facts constitute duress? We think not. Under the appellant's testimony, he had unlawfully appropriated money which belonged to respondent. The respondent had a right to say to him that, if he did not settle, it would commence a civil action. It also had a right to point out to him that he was subject to a criminal prosecution. Under his own testimony, the good faith of the charge that he was subject to criminal prosecution cannot be questioned. It is not duress for one who in good faith believes that he has been wronged to threaten the wrongdoer with a civil suit; and if the wrong

> includes a violation of the criminal law, it is not duress to threaten him with a criminal prosecution. . . ."

Judge Black concluded in his written opinion (R. 257-265) that the corporation had not made any demand upon Hansen (R. 258) and his wife—and without a demand by the corporation, the corporation cannot be charged with legal duress. Apart from such conclusion, Hansen's testimony is replete with admissions that he defrauded and swindled the stockholders and fraudulently induced the original purchase of stock, subsequent stock and loans. The stockholders did not know of his drawing account, and he did not tell them of it (R. 117, 119, 129). The summary of unreported testimony and reported testimony of the witnesses, Dr. Chatalas (R. 185, 255); Dr. Kiefer (R. 177, 247); Dr. Dougherty (R. 182, 228); and Dr. Jankelson (Tr. 202) clearly shows the fraudulent conduct of Hansen. Hansen was aware of all this at the conference with Mr. Carney and Mr. Ernest Jonson, and their testimony was that these fraudulent matters were discussed, and Hansen admits that probably some of it was brought out at that time (R. 95-96, 125, 91). There was therefore a basis for a claim on behalf of the corporation—a basis for a claim in good faith against Hansen. There was no force. Hansen voluntarily left the office and returned of his own volition (R. 89-90, 81-92) with his wife. Under the facts and circumstances as above set forth, there can be no conclusion but that as stated by Judge Black (R. 259-260):

> "He had a moral and legal obligation to try to

> return to the corporation the funds which he had taken without authority."

and

> "His conveyances and transfers were voluntary on his part, stimulated by *his* idea that it was good policy for him to make the transfers with the hope that the stockholders would not proscute him."

Under the law of the State of Washington as decided by its Supreme Court heretofore cited, legal duress was not proven by Hansen. His testimony, such as it was, is not worthy of belief as against the testimony of Mr. Carney (R. 231-234) and Mr. Jonson (R. 241-243). The cases cited by appellant do not control this question which is controlled by the Washington law. The Washington case cited by appellant is not in point.

ARGUMENT IN ANSWER OF APPELLANT'S POINTS

1. Appellant contends on pages 37-39 of his brief that

> "IV.
>
> "The District Court Had No Jurisdiction to Award Any Funds in the Hands of the Trustee to the Receiver."

and asserts that the Receiver should have filed a claim in the bankruptcy proceedings as a secured creditor. This is actually part of the basic question—was the property in question that of the bankrupt or in part that of the corporation. If the corporation traces its funds into the property, the corporation is not a creditor, but a property owner. The statute and case cited by appellant are not in point.

2. Appellant contends on pages 39-40 of his brief that

"V.

"The Receiver Waived Any Claim He May Have Had to Any Specific Property of Bankrupt and Elected To Become a Creditor."

The basic question, again, is whether the property in question was that of the bankrupt or in part that of the corporation. The Receiver by resisting the claims of ownership of Hansen does not thereby waive the claims of the corporation as an owner of part of the property under the equity tracing rule. Appellant appears to argue, from the case cited, that the corporation elected to become a general creditor, which is an entirely different argument from that in his heading. The cited case is not in point since the transaction in question was not a security transaction—it was a conveyance of property by deed and bill of sale and not the giving of a mortgage.

3. Appellant's contentions on pages 40-42 are believed to be fully answered in Appellee's brief in the first question discussed in the Argument in Support of Judgment in Favor of Appellee.

4. Appellant's remaining contention on pages 42-46 is believed to be fully answered in Appellee's brief, in the last question discussed in the Argument in Support of Judgement in Favor of Appellee.

CONCLUSION

We respectfully submit:

That the Findings of Fact of the Referee in Bankruptcy were clearly erroneous in that there was no evidence to support them; that the Conclusions of Law and the Order of the Referee in Bankruptcy were clearly erroneous.

That the Order of the District Court on petition for review should be affirmed in every respect insofar as it awarded judgment to the Appellee, Receiver of Vita-Pakt Associates, Inc.

Respectfully submitted,

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